

LR #1

Direct the Treasury Department to Develop a Plan to Reverse the “Pay Refunds First, Verify Eligibility Later” Approach to Tax Return Processing

PROBLEM

The IRS currently processes income tax returns before it has a chance to process information returns, including Forms W-2, *Wage and Tax Statement*, and Forms 1099, which report interest, dividends, and other payments. This sequence makes little logical sense. It requires the IRS to make tax payment and refund decisions on the basis of unverified information, creates opportunities for fraud, and prevents the government from making pre-populated returns available as an option to taxpayers. Moreover, the processing of tax returns and refund claims before the processing of information returns limits the IRS’s ability to effectively administer refundable credits. Most significantly, this system can result in the IRS making improper payments or unreasonably delaying the payment of refunds to eligible taxpayers.<sup>1</sup>

EXAMPLES

The following examples illustrate the problems that arise because the IRS cannot verify information before it processes tax returns and issues refunds:

Example 1: Inadvertent Misreporting.

A taxpayer files a return and inadvertently fails to report \$1,500 in interest income received from a bank account. The IRS has not yet received and processed Forms 1099-INT, *Interest Income*, so it processes the return as filed. Later, the IRS processes Forms 1099-INT, discovers the underpayment, and sends the taxpayer a notice requesting payment of \$525 in additional tax, plus interest and penalties. From the taxpayer’s perspective, this creates unnecessary burden and requires him to pay more than the tax owed. From the government’s perspective, the IRS must devote resources to recovering refunds that should not have been paid, and it is often unable to recover delinquent liabilities, reducing revenue collected.

Example 2: Fraudulent Refund Claims.

A criminal files a fraudulent tax return on January 20, 2009, showing a tax liability of \$10,000 and income tax withholding of \$15,000. On the face of the return, the “taxpayer” is entitled to a refund of \$5,000. However, the IRS does not gain access to Form W-2 information until later in the year, so it must determine whether to pay the refund before it can “document match” the return against the Form W-2 filed by the employer (which

<sup>1</sup> See *Running Social Programs Through the Tax System*, vol. 2, *infra*.

would show both the taxpayer’s total wages and the tax withheld). While the IRS uses fraud detection software to try to identify fraudulent claims, the software cannot detect all improper claims. The IRS could avoid paying out false and fraudulent claims involving Form W-2 information, without unreasonably delaying legitimate refunds, if it had access to this information when it processes the claims.

### Example 3: Feasibility of Pre-Populated Tax Returns.

During the 2008 presidential campaign, President Obama’s tax plan included a proposal to “giv[e] taxpayers the option of pre-filled tax forms to verify, sign and return.”<sup>2</sup> In light of the significant amount of time and money Americans spend on tax preparation,<sup>3</sup> this idea is worth considering, but it is not feasible at this time. The tax filing season begins in mid-January each year, and many taxpayers, especially those who file simple returns and are owed refunds, file in January or early February. However, the IRS currently does not receive Forms 1099 from financial institutions until later in the filing season and does not begin receiving Form W-2 data from the Social Security Administration (SSA) until late March.<sup>4</sup> Therefore, the IRS cannot create a pre-filled return until much later than most eligible taxpayers would be willing to wait.

## RECOMMENDATION

The National Taxpayer Advocate recommends that Congress direct the Treasury Department to prepare a report identifying the administrative and legislative steps required to allow the IRS to receive and process information reporting documents before it processes tax returns. The Treasury Department should be given a full year to prepare its report in light of the complexity of the issue and the actions that would be required of the IRS, the SSA, private employers, and financial institutions. The goal should be to fully implement required changes within five years from the time the report is completed.

## PRESENT LAW

### Forms W-2

IRC § 6051(a) requires employers to provide employees with a written statement each year showing, among other things, the amount of wages paid and the amount of tax deducted and withheld. The statement must be furnished to the employee no later than January 31 of the year following the year in which the wages were paid.

<sup>2</sup> See *Barack Obama's Comprehensive Tax Plan* at [http://www.barackobama.com/pdf/taxes/Factsheet\\_Tax\\_Plan\\_FINAL.pdf](http://www.barackobama.com/pdf/taxes/Factsheet_Tax_Plan_FINAL.pdf) (last visited Dec. 15, 2009).

<sup>3</sup> A TAS analysis of IRS data shows that the costs of complying with federal income tax requirements comes to about \$193 billion a year and that U.S. taxpayers and businesses spend about 7.6 billion hours a year complying with the filing requirements of the Internal Revenue Code (IRC). For a discussion of these burden estimates, see National Taxpayer Advocate 2008 Annual Report to Congress 3-14 (Most Serious Problem: *The Complexity of the Tax Code*).

<sup>4</sup> IRS response to TAS information request (Sept. 29, 2009).

IRC § 6051(d) provides that a copy of the statement must be filed with the Secretary “in accordance with regulations prescribed by the Secretary.” Significantly, the regulations prescribed by the Secretary direct employers to file Forms W-2 not with the IRS but with the SSA.<sup>5</sup> The deadline for filing Forms W-2 with SSA is the last day of February for paper returns and the last day of March for returns filed electronically.<sup>6</sup>

Under current procedures, SSA receives all Forms W-2 – most electronically, some on paper – and then compares the name/Social Security number (SSN) combination on each Form W-2 against its SSN database to determine whether the name and number match. Name/SSN mismatches may arise for a variety of reasons. In some cases, the earnings should be attributed to the worker listed on Form W-2 (*e.g.*, when “Robert Jones” uses “Bob Jones” on his employment paperwork or when a woman marries and takes her husband’s surname but fails to inform SSA). In other cases, the earnings should not be attributed to the worker listed on Form W-2 (*e.g.*, when an undocumented worker illegally uses another person’s SSN to obtain employment). When SSA receives Forms W-2 with names and SSNs that do not match, it uses a variety of automated processes in an attempt to correct mismatches that likely are inadvertent.<sup>7</sup>

SSA sends relevant information extracted from Forms W-2 to the IRS in electronic form. SSA begins to send the data extracts to the IRS on a weekly basis in late March (*i.e.*, the deadline for employers to submit Form W-2 information electronically to SSA) and continues to send them on an ongoing basis as it completes its validation processes. The IRS generally holds the information until mid-May, when it begins to build its Information Returns Master File (IRMF) database for the preceding year. Once the IRMF database is built, all validated data extracts received from SSA are processed within one week and loaded onto the IRMF. Significantly, the IRS does not receive information from some Forms W-2 until the second half of the calendar year.<sup>8</sup>

For tax year (TY) 2007, the IRS received 244 million Form W-2 records from SSA. Of those, SSA reported that 8.9 million (less than four percent of the total) contained name/SSN mismatches that it could not correct using its automated processes. The IRS accepts without further verification all Form W-2 information that SSA has validated but applies its own automated processes (known as “Taxpayer Identification Number ferreting”) to try to validate the records that SSA reports as containing name/SSN mismatches. In TY 2007,

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Treas. Reg. § 31.6051-2(a). Prior to 1978, employers filed Forms W-2 with the IRS. In 1978, regulations were issued instructing employers to begin filing Forms W-2 with SSA as part of a set of changes designed to implement the Combined Annual Wage Reporting (CAWR) program. See T.D. 7580, 1979-1 C.B. 378.

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Treas. Reg. § 31.6071(a)-1(a)(3)(i).

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For a detailed discussion of the SSA’s processes, see Government Accountability Office, GAO-06-458T, *Social Security Numbers: Coordinated Approach to SSN Data Could Help Reduce Unauthorized Work* (Feb. 16, 2006) (testimony before the House Ways and Means Subcommittees on Social Security and on Oversight).

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IRS response to TAS information request (Sept. 29, 2009).

the IRS was able to “perfect” about 100,000 of the 8.9 million records reported by SSA as containing name/SSN mismatches.<sup>9</sup>

### Forms 1099

The tax code generally requires payors of interest, dividends, and other income to provide recipients with a written statement each year showing, among other things, the aggregate amount of the payments.<sup>10</sup> The statement generally must be furnished to the recipient no later than January 31 of the year following the year in which the income was paid.<sup>11</sup>

The tax code generally provides that a copy of the statement must be filed with the Secretary “according to the forms or regulations prescribed by the Secretary.”<sup>12</sup> Treasury regulations generally direct payors of income to file Forms 1099 with the IRS no later than the last day of February for paper returns and the last day of March for returns filed electronically.<sup>13</sup> Thus, unlike the process for Forms W-2, the IRS receives Forms 1099 directly and processes them itself.

As with W-2 information received from SSA, the IRS loads Form 1099 information received from payors of income onto its Information Returns Master File database. The IRS, as noted above, builds the IRMF database in mid-May for the preceding year. Therefore, Form 1099 information is not processed until after the filing season has ended.

## REASONS FOR CHANGE

The current system of “pay refunds first, verify eligibility later” is essentially an upside-down sequence that makes little sense, harms taxpayers, and undermines tax compliance. From a taxpayer perspective, the process leads to millions of cases where taxpayers inadvertently make overclaims that the IRS does not identify until months later, exposing the taxpayer not only to a tax liability but to penalties and interest charges as well.<sup>14</sup> This is a burden that can and should be prevented.

Similarly, from a tax compliance perspective, the sequence leads to the payment of unwarranted refunds that the IRS must devote resources to recovering. In FY 2009, the IRS reports that it collected \$4.6 billion through its document-matching program.<sup>15</sup>

<sup>9</sup> IRS response to TAS information request (Sept. 29, 2009).

<sup>10</sup> See, e.g., IRC § 6049(a) & (c) (relating to interest payments); IRC § 6042(a) & (c) (relating to dividend payments).

<sup>11</sup> See, e.g., IRC § 6049(c)(2)(A) (relating to interest payments); IRC § 6042(c) (relating to dividend payments). However, IRC § 6045(b) gives brokers until February 15 of the year following the year in which income is paid or recognized to furnish customers with information statements.

<sup>12</sup> See, e.g., IRC § 6049(a) (relating to interest payments); IRC § 6042(a) (relating to dividend payments).

<sup>13</sup> See, e.g., Treas. Reg. § 1.6049-4(g)(1) (relating to interest payments); Treas. Reg. § 1.6042-2(c) (relating to dividend payments).

<sup>14</sup> For TY 2005, the IRS document-matching program (known as the Automated Underreporter (AUR) program) made 2.3 million tax assessments amounting to \$5.5 billion dollars. IRS Compliance Data Warehouse, Individual Master File (TY 2005). While many taxpayers voluntarily pay the amounts assessed, the IRS often must resort to enforcement action. The IRS reports that it received approximately 265,000 levy payments resulting from its TY 2005 tax assessments. *Id.*

<sup>15</sup> See IRS, Fiscal Year 2009 Enforcement Results at [http://www.irs.gov/pub/irs-drop/fy\\_2009\\_enforcement\\_results.pdf](http://www.irs.gov/pub/irs-drop/fy_2009_enforcement_results.pdf) (last visited Dec. 23, 2009).

Additional amounts are assessed but not collected.<sup>16</sup> On the criminal side, the IRS Criminal Investigation division blocked \$1.5 billion in false and fraudulent refund claims in calendar year 2009, but was unable to stop known claims of about \$500 million that were not detected as false or fraudulent until paid, plus an unknown volume of additional improper claims.<sup>17</sup> Thus, the current system requires the IRS to devote significant resources to recovering refunds that should never have been paid out and makes it impossible for the IRS to retrieve all excess payments, even with its extensive collection tools.

Current processes also preclude the creation of pre-populated tax returns on a timely basis, or even making third-party data available for taxpayers to download to tax software programs. While the logistics of creating pre-populated returns requires further study, a decision should be made on the merits of the proposal – not by default simply because the IRS lacks the ability to create them.

If the IRS were to process information returns before it processes tax returns and claims for refund, honest taxpayers would be spared from unnecessary IRS assessment and collection action, more fraudulent claims would be stopped, and revenue collection would rise.

### EXPLANATION OF RECOMMENDATION

The National Taxpayer Advocate recommends that Congress direct the Treasury Department to develop a report identifying the administrative and legislative steps required to allow the IRS to receive and process information reporting documents before it processes tax returns.

In light of the complexity of the issue and the actions that would be required of the IRS, SSA, private employers, and financial institutions, the Treasury Department should be given a full year to develop its report. The IRS and Congress should then aim to implement the required changes within five years from the time the report is completed.

Two potential changes should be evaluated carefully. One is to move up the deadline by which employers and payors of income must file information reporting documents with the government. The other is to move back the date on which the IRS begins to process tax returns and claims for refund. In both cases, the burden these changes would impose requires study. Employers and financial institutions need time to prepare information returns after the close of the year, and taxpayers who are entitled to refunds should not be forced to wait for an extended time to receive them. Low income taxpayers, in particular,

<sup>16</sup> For TY 2005, more than 300,000 taxpayers still owe about \$1.5 billion (including interest and penalties) where the major source of assessment was the AUR program. IRS Compliance Data Warehouse, Individual Master File (TY 2005).

<sup>17</sup> During calendar year 2009 (through Dec. 2), the IRS’s Questionable Refund Program identified about 280,000 false and fraudulent returns claiming refunds of about \$1.9 billion. Of that total, the IRS disallowed about 192,000 claims, preventing the payment of about \$1.4 billion. The IRS reports that the vast majority of false and fraudulent refund claims involves income and/or withholding amounts ordinarily reported on Form W-2. IRS response to TAS information request (Dec. 16, 2009).

may have difficulty, at least initially, adjusting to any changes in their accustomed time-frame for receiving refunds.

The following is a partial list of issues that the report should address:

1. ***Moving up the deadlines by which employers must file Forms W-2 and financial institutions must file all or at least the most common Forms 1099.*** As described above, Forms W-2 and most Forms 1099 must be issued to the taxpayer by January 31. Under present law, issuers who file these forms electronically have another two months (until March 31) to file the forms with the government. With the advancements in automation and sufficient lead time, it seems reasonable to expect that employers and financial institutions will be able to file reports with the government at the same time they issue them to employees and customers – namely, by January 31.
2. ***Mandating that virtually all information returns be filed electronically.*** When the government receives information on paper returns, its ability to process the information is delayed by the need to route the returns and to transcribe the data manually. Manual data entry unavoidably results in transcription errors as well. Some e-filing mandates are already in place, but consideration should be given to imposing more extensive mandates for the filing of information returns, including requiring e-filing by anyone who uses a tax return preparer or tax software. Carve-outs should be limited to employers or payors of income who are issuing information returns to less than a specified number of recipients (*e.g.*, an elderly person without a computer who employs a single household employee or nurse).
3. ***Working with SSA to expedite the processing and transmission of Form W-2 data.*** As discussed above, employers file Forms W-2 with SSA – not with the IRS – and SSA screens the forms to identify name/SSN mismatches before it transmits data extracts to the IRS. The length of time between SSA’s receipt of W-2 data and its transmission of data extracts to the IRS should be assessed. If there is a significant lag, the report should consider various options to reduce the delay, including processing improvements within SSA and whether the IRS could receive Form W-2 data directly from employers and perform the screens itself, as it did prior to 1978.<sup>18</sup> If there is a significant lag, the IRS should also conduct a test to determine whether it can screen W-2s as effectively as SSA. While SSA “owns” the SSN database, the IRS has considerable data of its own and may be able to use this data as effectively to clear up mismatches.
4. ***Expediting the IRS’s ability to process information returns.*** As discussed above, the IRS does not begin building its IRMF database until after the filing season. The report should assess ways for the IRS to build the database in real time, as information returns are received.

<sup>18</sup> The IRS and SSA both need Form W-2 data, albeit for different reasons. Therefore, if the IRS develops the capacity to screen for name/SSN mismatches and can complete the task more quickly than SSA, consideration should be given to creating a joint processing center. Employers could be directed to submit Forms W-2 to the joint processing center, and the IRS and SSA would both have immediate access to the data. Alternatively, a portal could be created to give the IRS direct access to the SSA database, and both agencies could make use of the data in that way.

5. *Developing or refining the IRS’s ability to run income tax returns and claims for refund against the IRMF database to identify disparities before paying refunds.* Even if the IRS is able to load complete information onto the IRMF database, it does not follow automatically that the IRS could screen all refund claims against the database in a timely manner. To the extent it cannot do so, its return processing systems would have to be modified so that the IRS can run an IRMF screen simultaneously with its other screens.
6. *Delaying the start of the filing season without unduly delaying the delivery of refunds to taxpayers.* While our preference would be to accelerate the development of the IRMF database to the point where a delay in the start of the filing season is not necessary, the tight timeframe makes that implausible. Therefore, consideration should be given to delaying the start of the filing season without imposing undue burden on taxpayers. At present, more than 80 percent of taxpayers overpay their taxes each year (usually due to overwithholding) and are entitled to refunds.<sup>19</sup> For some, including low income taxpayers, these refunds amount to several thousand badly needed dollars. If the IRS delays the processing of tax returns, these taxpayers will have to wait another month or possibly more to receive their refunds. The IRS should think creatively about ways to prevent undue burden. One area of focus should be on ways to reduce overwithholding by adjusting the withholding tables. Another option would be to revamp the Advance Earned Income Tax Credit (which has seen very low usage rates) or pay out other benefits ratably during the year to reduce the size of refund payments.
7. *Evaluating how other countries approach the filing season.* The United States, of course, is not the only country that faces the challenge of collecting taxes after the close of a tax year. The National Taxpayer Advocate has met with tax administrators from numerous countries, and they utilize a wide variety of approaches, including setting earlier deadlines for information reporting and starting the filing season substantially later in the year. The IRS should study some of these approaches to develop best practices that balance the goals of (a) processing tax returns only after information returns are received and (b) limiting any burden that delays may impose on taxpayers.
8. *Making use of information returns to create pre-populated returns for taxpayers with simple tax situations.* As discussed above, pre-populated returns could substantially simplify tax preparation for millions of Americans. California offers pre-populated returns for some taxpayers (i.e., the “ReadyReturn” program)<sup>20</sup> as do some other countries (e.g., Sweden and Australia). The IRS should study these programs and test a pilot program of pre-populated returns with a small group of taxpayers.
9. *Making data from information returns available for taxpayers to download.* Once the IRS has received and processed Form W-2 and Form 1099 information returns, it

<sup>19</sup> See IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2009).

<sup>20</sup> For information on the pre-populated return program implemented in California, see Joseph Bankman, *Simple Filing for Average Citizens: The California Ready Return*, 107 Tax Notes 1431 (2005); State of California Franchise Tax Board, *ReadyReturn General Information*, available at <http://www.ftb.ca.gov/readyreturn/about.shtml> (last visited Dec. 22, 2009).



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should be able to make the data available for taxpayers to download to their software programs. The IRS should explore the feasibility of making this data available, balancing taxpayer convenience and data security concerns.

As this list illustrates, the task of moving the processing of information returns ahead of the processing of tax returns is not simple. With proper planning and sufficient lead time for implementation, however, we believe it could provide significant benefits for both taxpayers and the IRS.